What Constitutes a Reasonable Underwriting Profit

and

The Method of Determining Same

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Certain queries were embodied in resolutions presented at the annual meeting of the National Convention of Insurance Commissioners held in Hartford in September, 1919, which resolutions were transmitted to F. C. Buswell, President of the National Board of Fire Underwriters under date of October 25, 1919, by Honorable Joseph Button, Commissioner of Insurance of the Commonwealth of Virginia and Chairman of the Committee on Fire Insurance of the Commissioners' Convention.

The following constitutes a partial answer to the questions thus propounded.

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FIRST

WHAT CONSTITUTES A REASONABLE UNDERWRITING PROFIT?

Reasonable Underwriting Profit.

An equitable regard for the investors who furnish the capital for this particularly hazardous business would indicate that 5% is the minimum percentage which can be regarded as "a reasonable underwriting profit." This has already been recognized as equitable by several states.

The Method of Determining Same (Whether Paid or Earned Premiums, and Paid or Incurred Losses and Expenses)?

Earned Premiums.

The laws of the several states very properly require that the portion of the PREMIUMS unearned be set aside in a reserve fund until such earnings accrue. Since the company's surplus is augmented only by the portion of the premiums earned and removed from such reserve and only the portion earned can be treated as an element in computing the profit result as shown in the annual statements made in accordance with such legal requirements, companies should not be expected to return the full amount of premiums paid in, but only such amount as is earned.

Incurred Losses.

As to LOSSES, the principle is even more obvious that incurred losses, and not paid, is the only proper basis. A simple and convincing illustration of this principle is afforded by the case of a company which suffers a conflagration loss, or losses of considerable magnitude, just prior to the end of the year. In reporting on a paid basis such losses would not appear at all, owing to the fact that there had not been sufficient opportunity to adjust and pay them before the end of the year; consequently, the result would be wholly inaccurate and misleading.

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Incurred Expenses.

EXPENSES incurred are usually also paid, but at the end of the year, there are quite large sums particularly of federal, state and other taxes which companies have incurred by doing business for the year then ending, but which are not payable until some date in the following year, and which have not even been determined when the year closes. Necessarily, reserves have to be set up for items of this character, whether taxes or otherwise, and to this extent incurred expenses should be allowed for. In other words, we endorse the method of the Insurance Commissioners as laid down for the underwriting exhibit of the Convention Annual Statement Blank; namely, earned premiums against incurred losses and expenses.

The Proper Number of Years on Which to Base Such Calculation?

Experience Period.

Insurance as a business is governed by the law of averages, and one year's experience is insufficient to establish a dependable experience. The laws of such states as have recently made enactments on the subject, as for example, Arkansas and Colorado, have recognized that a five-year period is the minimum over which a dependable experience of underwriting profit or loss can be established.

SECOND

WHETHER IN SUCH CALCULATIONS INCOME AND EXCESS PROFITS TAXES ARE TO BE ALLOWED AS AN EXPENSE?

Federal Taxes

Federal income and excess profits taxes are among the heaviest burdens as to expense under which the companies labor. Some states also have enacted taxes of like character. It is clear that no determination of profit can be made which ignores these very heavy items of expense. It is idle, as well as unjust, to compute a

paper profit from which further deductions must be made before an actual profit is available as a result of doing business, to the parties whose capital is hazarded in the enterprise. All deductions of losses and expenses should be made before the production of any figure regarded as profit.

No corporation organized for profit and depending for its existence upon a reasonable return to its stockholders from its operations could continue if due credit were not given for all costs of operation which go to reduce the amount of its net income, upon which its return to stockholders is predicated.

THIRD

WHETHER ANY ITEMS OF PROFIT OR LOSS CONNECTED WITH THE SO-CALLED BANKING END OF THE BUSINESS SHOULD PROPERLY BE TAKEN INTO CONSIDERATION?

Non-Participation.

Stock fire insurance is carried on by companies having a capital stock divided into shares contributed not by the policyholders in any part but solely by the stockholders. The business is managed by directors chosen solely by the stockholders and in which the policyholder has no interest or voice. Every policyholder in such a company enters into his engagements with the company as such without regard to any other policyholder. He pays the premium upon his policy not for the purpose of insuring any other person but solely as a consideration for his own insurance and the indemnity he is to receive in case of loss. The company receives the money as its own and holds it as its own and may do with it what it sees fit, except as it is restrained by some statute. It is wholly immaterial to the insured what the company does with the money or what disposition it makes of it, provided it remains solvent and is in position at all times to pay any contractual obligation.

There is nothing in the organization or conduct of a stock company which gives the right to a policyholder to expect any participation in the earnings of the company, whether it be investment earnings or otherwise, and there is no substantial difference, so far as participation is concerned, between the actual return of a part of such investment earnings and the application of a part of the investment earnings to the reduction of rates.

Accounting Treatment of Investment Earnings.

Stockholders are entitled to a profit for assuming the hazard against loss, this being the particular enterprise the company engages in. If they also put up large sums of money which are held invested, return on such investments has nothing to do with the results of underwriting. If the stockholders choose, they could invest the money in the same securities without subjecting their investment to the chance of loss due to the hazards of the insurance business, and without going to the trouble and expense of conducting the insurance business. Clearly there would be no incentive to engage in the business of insurance if this income which they could obtain from their investments in any case is not recognized as a rightful return to the stockholders irrespective of what they gain or lose from their contracts of indemnification against loss. Furthermore, if the underwriting end of the business is to be credited with the proceeds of the investment branch, it will be found that there are a number of conditions, penalties, and handicaps under which the investment branch of the business is placed for the benefit of and to promote the business of the underwriting branch. The sums with which underwriting will have to be charged will probably exceed the sum with which it will be credited by beginning a series of charges and credits between the two branches of the business, which would also create a confusion in terms.

Distinction Between Profits From Operations and Returns from Investments.

Underwriting Subject to Charges in Favor of Investments.

Affirmative Premises.

The argument that income from funds comprising unearned premium reserve is underwriting income, rests upon the premises that while *earned* premiums alone are considered in computing underwriting profit or loss, full premiums are actually collected in advance; and such collection in advance of the time when earned, of premiums on the steady flow of business, maintains constantly in the hands of the companies, funds of many millions of dollars which yield an income to the companies, but for the use of which they do not have to pay.

Investment Losses and Depreciation.

But should losses from bad investments be charged to underwriting result? Should declines in market values be charged to underwriting result? Doubtless the advocates of the plan suggested by question "THIRD" will answer—"*no.* If you lose the money the policyholder prepays you, that has nothing to do with underwriting. The selection of bad investments is a hazard of the investment end of the business. The choice of investments which decline in value is a hazard of the investment department. These gains or losses have to do with skill in choosing investments and have nothing to do with underwriting." Thus, they would wish the companies to credit the underwriting result with the regular earnings from the investments, whereas losses, if any, would be charged to the investment result.

Interest Earnings.

But are not the regular earnings also a matter of skill in choosing investments? And if so, why should earnings which accrue from the use and application of such skill be credited to underwriting result? Why should underwriting result be concerned with what companies do with the advanced premiums? That has nothing to do with the relation of premium to hazard, which is the essence of underwriting. A company may invest such funds where they yield 6%, or may leave them in a bank where they draw but 2%, or may invest them where there is promise of a good return, but where, owing to any one of many possible causes, the invest-

ment fails to make any return. Why should underwriting result reflect any one of these conditions which result from the exercise of investing judgment? Why, in short, should the question of the use of money enter into a problem properly involving only the relation between the premium and the hazard for which it is charged together with the expense incident to doing the business?

Companies' Position.

Even if the advocates declare their willingness to admit the use of gains and losses, and advances and declines in the market values, along with the regular earnings from funds comprising the reserve and contend that all these elements to the extent that they affect unearned premium reserve funds should be allowed for in computing underwriting result, still the companies object for two reasons:

Relation of Premium and Hazard.

(1st) They hold that underwriting is a matter involving on the one hand the premium; on the other the expenses of transacting the business and the hazard of loss. Interest is not received except as funds are loaned or invested, and the loaning and investment of funds has no connection with the relation of premium and hazard;

Income from Reserve Fund—How to Ascertain.

(2nd) If they were to use the income from reserve as a credit to underwriting, how should it be ascertained? Which investments comprise the reserve and which the surplus? Possibly the method would be as follows: Add the gross assets at the beginning and end of the year, and average them. Add the reserve at beginning and end of year, and average it. Ascertain the proportion which the average reserve bears to average gross assets. Assign to underwriting result such proportion of all income from interest, dividends and rents, all profit on sales or redemption of assets, all increases in market values. Charge to underwriting result such proportion of losses on sales or redemption of assets and all declines in market values.

If a company's gross assets are $21,000,000 and its

reserve $9,000,000, by this plan approximately .4285 of all investment income gains and losses would be carried to underwriting result, as follows: *Illustration of Anomalous Result.*

	Total	Underwriting Result	Investment Result
Interest, Dividends and Rents	$750,000	$321,375	$428,625
Gains on Sales and Redemption	8,000	3,428	4,572
		$324,803	$433,197
Losses on Sales and Redemption	150,000	64,275	85,725
Declines in Market Values	240,000	102,840	137,160
		$167,115	$222,885

Confusion in Terms.

The result demonstrates the absurdity of this procedure; since actual investment income is here so arbitrarily cut asunder and partially assigned to "underwriting result," as to render the maintenance of any distinction between underwriting and investment results a mockery; for the two would be inextricably intertangled, and neither phrase would thereafter have any significance agreeing with its apparent meaning.

Effect of Reserve Requirements On New Company.

It is generally understood with sufficient clearness that when a new company enters business, the amount which it is required to set aside in the reserve fund as unearned, together with the expense disbursements it is obliged to make without waiting to earn the premiums, and such losses as it incurs very greatly exceed the sum of the premiums written and would create an impairment of capital did not the stockholders pay in enough surplus to tide it over this condition until such time as a sufficient earned surplus can be created, which usually requires several years, perhaps ten.

Illustration.

For example, a new company writes premiums of $1,000,000.

It is fair to assume the reserve for such first year 60%, or $600,000

Expenses	.....40%	400,000
Losses	.....25%	250,000
		$1,250,000
Impairment		250,000

Premiums assumed to be composed of the following:

Annual.	$720,000	50% reserved.	$360,000
3 years.	180,000	5/6 " .	150,000
5 years.	100,000	9/10 " .	90,000
	$1,000,000		$600,000

Effect of Reserve Requirements on Established Company.

It is not so generally realized that the *same conditions* necessarily exist with the *oldest* and *strongest* companies, having the largest surplusses, in respect of the writings of each successive year. After paying the year's expenses, setting aside the required reserve and settling the losses on current writings only, the premiums from such current writings will invariably be exceeded. How, then, is this deficit made up, as regards an established company? Not by the sums taken out of the reserve as earned on business written in previous years, reserves for which were set up in the year when written. The company is entitled to carry these sums over to its earned surplus as fast as the fact of their having been earned removes them from the reserve. It is out of this *earned surplus* itself that each company must advance the funds necessary to make up the deficit resulting from the combination of reserve, expense and losses attaching to each successive year's business put on the books. Therefore every company, no matter how strong, must suffer a depletion in its surplus in favor of the reserve in respect of the business put on the books in the current year, from that which the surplus would otherwise be, and an accurate accounting between the underwriting and investment departments would require that *underwriting* be *charged* and *investments credited* with

the use of the funds which each year are thus borrowed from the surplus.

To correct any impression that 60% is too high a reserve to assume on current writings in view of the fact that the reserve funds of established companies frequently run about 53% of their *outstanding* premiums, the following table will demonstrate that these elements are totally different and these percentages not at all irreconcilable:

For example, in case the proportions as to term business were in detail as displayed in the foregoing, the record for three years would be as follows:

Illustration.

	Premiums	Reserve
First year, per detailed exhibit....	$1,000,000	$600,000
Second year, annual business runs off	720,000	
Reserve runs off as follows:		
Annual 1/2 .....$360,000		
3 years 1/3..... 60,000		
5 years 1/5..... 20,000		440,000
	$ 280,000	$160,000
Second year's writings (same proportions as first year).....	1,000,000	600,000
	$1,280,000	$760,000
Third year—Annual business runs off	$720,000	
Reserve runs off:		
1st year writings:		
Annual		
3 years 1/3..... $60,000		
5 years 1/5..... 20,000		
2nd year writings:		
Annual 1/2.....$360,000		
3 years 1/3..... 60,000		
5 years 1/5..... 20,000		$520,000
	$ 560,000	$240,000
Third year's writings (same proportions as previous years).....	1,000,000	600,000
	$1,560,000	$840,000

Percentage of Premiums Reserved.

Proportion of reserve to outstanding premiums at this point .538, arrived at, however, by setting aside 60% in each successive year, showing that this percentage of each year's business is not too high to reflect the experience of companies. In fact, the experience as shown by the following actual figures, relating to a certain company's business for the year 1917, shows a still higher per cent of reserve, namely 67.9%, which would indicate the theoretical reserve of 60% per the preceding figures is probably too low.

Capital Held at Disposal of Underwriting Operations.

Consideration should also be given the amount of capital trusted out, not at interest, in unpaid agent's accounts (the amount of which as shown in the annual statement is not a fair average as companies, generally, make a special effort to collect balances before the end of the year), amounts of capital advanced in payment of losses before due, etc. In short, there are many elements which invested capital could charge against underwriting and if we open up the question of charges and countercharges, we shall inevitably have "underwriting result" and "investment result" hopelessly involved and confused, and both phrases stripped of their plain and proper meanings.

Actual Company Experiences.

Following is a graphic illustration of the relations between the underwriting and investment departments of the business, based upon the actual experience of the company in question for the year 1917, so that the figures are not representing a hypothetical case, manufactured for the sake of producing a pre-determined result, but are the conclusions drawn from the actual transactions of the year indicated, showing that if we embark on the policy of making charges and countercharges between the underwriting and investment departments, we shall find the underwriting department to be chargeable with very considerable amounts not now charged them, which presumably, as in this case, will exceed the amount of credits which the proponents

of the plan to consider interest on the reserve would assign to the underwriting department.

Analysis of Premiums for Reserve.

Net fire premiums were $10,869,735. The reserve table shows annual business on the books $5,362,830. As all annual business in force at the end of the year must have been written during the year, and as both the total net premiums and the annual premiums are expressed with reinsurance and cancellations out, it seems proper to deduct the annual from the total to determine the term business, which by this process, is found to be $5,506,905. As the proportion between three-year and five-year business outstanding written during the year is about .685 for three-year and .315 for five-year business, we divided the term premiums above indicated in these proportions which produced $3,772,230 three-year premiums, and $1,734,675 five-year premiums. The result is as follows:

	Premiums		Reserve
Annual premiums	$5,362,830	50%	$2,681,415
Three years	3,772,230	83 1/3%	3,143,524
Five years	1,734,675	90%	1,561,208
Total	$10,869,735		$7,386,147

Expenses.

The actual experience of the company referred to for that year is that incurred underwriting expenses were 38 5/10% of the premiums *written.*

Losses on Current Business.

Losses are not readily divisible between those occurring under policies written in 1917 and those under policies previously written, so that an estimate is necessary in allowing for losses on the business of the current year, but experience of companies, so far as available, would indicate that 25% is a conservative allowance for losses during the first year.

Reserve as indicated above results in a percentage of about 67 9/10 for the fire business.

The result follows, indicating how the actual gain from underwriting of $268,226 per the annual statement

Deficit on Current Business Made Up From Business Previously on Books.

is divided between accretions from business previously on the books due to the earnings for the year of the premiums on such business, less the losses ($3,619,488), as against impairment, resulting from the current year's business put on the books subject to expenses, losses and a charge for reserve as indicated above ($3,351,262).

	Current Business		Business Previously on Books		Total	
	Income	Outgo	Income	Outgo	Income	Outgo
Net Premiums.....	$11 399,603				$11,399,603	
Losses incurred 25%		$2,849,901		$2,737,635		$5,587,536
Expenses incurred (38.5%)		4,391,357				4,391,357
Reserve 67.9% of fire business) plus marine reserve		7,508,764	$6,357,123			1,151,641
Misc. items.....		843				843
	$11,399,603	$14,750,865	$6,357,123	$2,737,635	$11,399 603	$11,131,377
		11,399,603	2,737 635		11,131,377	
Impairment, resulting from current business.....		$3,351,262				
Net accretion resulting from business previously on the books.....			$3 619,488			
Gain from underwriting per statement					$268,226	

PROOF

Net accretions from business previously on the books	$3,619,488
Impairment resulting from current year's business put on the books	3,351,262
Gain from underwriting, per statement	$ 268,226

Impairment Repeated Annually.

(1) Each year the new business put on the books will produce a new impairment, which will be made up, under favorable conditions, from the net accretions from previous year's business. But these accretions belong to the company by right of earning, irrespective of whether new business is done or not. Hence, it must

be recognized that in order to put the new business on its books the company has to advance from the funds which would otherwise be a part of the surplus the sum of $3,351,262 and to advance a like sum each year.

Underwriting Operations Chargeable with Amount of Impairment.

Underwriting operations are indebted to capital elements for the use of $3,351,262 (or a like sum), continuously, year by year.

Underwriting Operations Chargeable with Loss of Interest from Idle Capital.

(2) The charges for commissions and other charges in agents' and general agents' accounts vary considerably. General agency accounts contain charges of wide diversity of character and amount. Assuming such charges deducted before the accounts reach the company average 30% of the net premiums it follows that agents' balances equal 70% of the net premiums. Agents' balances created incidental to the placing on the books of $11,399,603 net premiums would thus be $7,979,722, and as the average term of credit is fully sixty days, equals an average of $1,329,953 of the gross assets continuously at the service of underwriting operations, without interest. Hence, underwriting operations are indebted to capital elements for the use of $1,329,953 (or a like sum), year by year.

Underwriting Operations Chargeable with Losses on Investments.

(3) If underwriting operations are to be credited with income from investments comprising the reserve, they must be charged with losses on sale or maturity of assets in that proportion which the reserve bears to the gross assets, as follows:

Loss on sale or maturity of ledger assets	$77,639
Gain on sale or maturity of ledger assets	5,329
Net loss on sale or maturity of ledger assets	$72,310
Gross assets	$19,794,891
Reserve	10,979,583
Proportion	.554
Proportion of net loss chargeable to reserve	$40,059

Underwriting Operations Chargeable with Depreciation.

(4) By the same reasoning underwriting operations must be charged with the loss in surplus due to the decline in market values, which for the company in question in 1917, is as follows:

Decline in market values.....$324,529
Proportion (.554) chargeable to reserve..... 179,789

Underwriting Operations Chargeable with Loss of Interest From Semi-Idle Capital.

(5) The necessity under which insurance companies are placed to maintain available cash in large sums relates primarily to the steady volume of losses which must be met and paid and the possibility of extraordinary losses, the means for payment of which must be readily at hand. During the year in question the company referred to kept average deposits in banks of about $2,000,000, the earning capacity of which, if invested in permanent investments, would have been about 5%, but which, owing to the character of the business, and the necessity for keeping this sum on hand, actually earned less than 2%, resulting in a loss of over 3% directly chargeable to requirements incidental to underwriting. Estimated loss in interest, chargeable to underwriting—$60,000.

Removal of an Unwarranted Credit Now Made to Underwriting Operations.

(6) Under the convention form statement there is an arbitrary charge to investment expenses of 1/8 of 1% on the mean invested assets which represents no actual outlay, but evidently what the brokers' commission would be if the whole amount of the mean invested assets were reinvested during the year. The only way this can be used as a charge against investments is to credit it to underwriting, and that is what is done, but underwriting is not entitled to this credit, because the charge is purely theoretical and arbitrary, and not the result of actual transactions. This transfer item for the company referred to, in 1917, was $17,831.

If charges and countercharges are to be made, the result will be as follows, assuming underwriting to be credited with 5% on the average amount of reserve:

	Debit	Credit	
Reserve at beginning of year, $9,827,-942; end of year, $10,979,583; total, $20,807,525. Average $10,403,762. Allowance on average reserve at 5%		$520,188	*Assumption of Prevailing Interest Rate at 5%.*
Item 1. Impairment from new business. Use of $3,351,262 at 5%	$167,563		
Item 2. Funds tied up in agents' balances; Use of $7,979,722 at average of 60 days equals $1,329,953 for one year at 5%	66,497		
Item 3. Proportion chargeable to reserve from loss on assets sales	40,059		
Item 4. Proportion chargeable to reserve for decline in market values	179,789		
Item 5. Loss of interest due to underwriting requirements for holding large sums available for losses	60,000		
Item 6. Restoration to underwriting expenses of the amount arbitrarily removed therefrom as a charge to investment expenses by the requirements of the convention form statement, namely 1/8 of 1% of mean invested assets, about	17,000		
	$530,908	$520,188	

From the foregoing it will be seen that the possible charges to underwriting exceed the possible credits to underwriting in case the question of accounting between the two is opened up and charges and credits are to be made. *Result of Offsetting Charges and Credits.*

Developing somewhat further the conclusions arrived at in the foregoing, the substitution of the average

rate of investment income earned on investments for the arbitrary rate of 5%, produces the following possibly more nearly correct results.

Assumption of Prevailing Interest rate of .0417.

This method differs from the previous method only in that instead of assuming an average interest rate of 5% we have taken the actual income in its relation to income producing assets, and obtained an average rate, which is .0417.

	Debit	Credit
Reserve at beginning of year, $9,827,942; end of year, $10,979,583; total, $20,807,525. Average $10,403,762. Allowance on average reserve at .0417		$433.836
Item 1. Impairment from new business. Use of $3,351,262 at .0417	$139,747	
Item 2. Funds tied up in agents' balances; Use of $7,979,722 at average of 60 days equals $1,329,953 for one year at .0417	55,459	
Item 3. Proportion chargeable to reserve from loss on assets sales	40,059	
Item 4. Proportion chargeable to reserve for decline in market values	179,789	
Item 5. Loss of interest due to underwriting requirements for holding large sums available for losses	43,400	
Item 6. Restoration to underwriting expenses of the amount arbitrarily removed therefrom as charge to investment expenses by the requirements of the convention form statement, namely 1/8 of 1% of mean invested assets, about	17,000	
	$475,454	$433,836

Result of Offsetting Charges and Credits.

By this method, underwriting is to be charged with $41,618 more than the credit amounts to.

The foregoing demonstrates that, both in theory and in practice, each new year's business put on the books of any company, however old and well established, creates an impairment, precisely as it does in the case of any new company just starting in business, also that there are a number of conditions, penalties and handicaps under which the investment department of the business is placed for the benefit of underwriting operations, which, if there is to be an accounting between the two departments, will have to be charged against underwriting. Furthermore, that whenever interest and dividend elements are taken out of investment income and treated as underwriting, a confusion in terms ensues by which the terms "underwriting income" and "investment income" become hopelessly confused and each robbed of its proper meaning. *Conclusions.*

FOURTH

DEFINE WHAT IS TO CONSTITUTE A CONFLAGRATION AND DETERMINE WHAT PART OF THE CONFLAGRATION WOULD BE PROPERLY CHARGEABLE TO THE STATE IN WHICH THE FIRE OCCURS.

A conflagration may be regarded as any casualty which produces a loss of a million dollars or more, and since underwriting profit as ordinarily computed based upon ordinary losses makes no allowance for the extra demands upon the companies for unusual and abnormal items of conflagration losses, an additional margin of underwriting profit should be allowed the companies annually to absorb such extraordinary losses as they occur. *Definition of Conflagration.*

The total fire and tornado premiums of stock companies, Mutuals and Lloyds, in the United States and Canada for the year 1917 are reported as $486,650,720. If we regard individual losses exceeding $1,000,000 as

conflagrations, such losses constituted over 11% of the net premiums, but, of course, the figures quoted are the property loss, and not the losses covered by insurance. On the other hand, they do not include hail and tornado losses. Insurance is yearly becoming more universal. If only one-half of the property destroyed in the large losses in the future is covered by insurance, and such losses continue at the average of the last thirteen years, the conflagration losses, using the above definition for illustration, would be over 5½% of the net premiums, and this is on fire loss alone, not taking into account hail and tornado. We, therefore, suggest 5% as a very conservative minimum reserve against conflagration. Great conflagrations cannot be charged to the state in which they occur, for the purpose of making rates in that state to produce an underwriting profit. The San Francisco loss resulted in property damage of $350,000,000, which it would be hopeless to expect the State of California to pay by an increase in the insurance rates. Such losses must be paid for by the premiums of the entire country, and if proper allowance is made in each state for the conflagration hazard, both within and without the state, from the premiums earned in each such state (and a reasonable underwriting profit provided after such deduction), this will be done.

Minimum Allowance for Conflagration Reserve.

Conflagrations Chargeable to Operations Over Entire Country.

FIFTH

TO OUTLINE A PLAN COMPLETE AS TO DETAIL, BY WHICH THE VARIOUS STATES CAN BE GUIDED UNIFORMLY IN MAKING THEIR ESTIMATES.

Principles.

The following plan is based upon the principles laid down in the Convention Blank for determining underwriting profit, which we believe to be correct:

I. PREMIUMS.

1. Gross premiums on risks written, less return pre-

miums and premiums for *all* reinsurances, whether in authorized or unauthorized companies, on property in the state during the year as reported in the annual statements after allowing for adjustment, if any, to include *all* reinsurances as defined above. *Earned Premiums.*

2. Add unearned premiums on outstanding business in the state at the end of the preceding year. *Formula.*

3. Deduct unearned premiums on outstanding business in the state at the end of the year under consideration.

4. Result: Premiums earned during the year under consideration.

Note: If companies do not carry their premium reserve separately by states, the unearned premiums should be estimated as follows:

(a) Unearned premiums of whole company as of the date desired as shown on Page 5 of annual statements.

(b) Net premiums written by the company during the year ending on the date desired as shown on Page 2 of annual statements.

(c) Net premiums written in the state for the period used in (b) computed in the manner set forth in Item 1 above.

(d) Compute the ratio of (c) to (b).

(e) Apply the ratio made by method (d) to the unearned premiums of whole company (see a).

Result: Estimated unearned premiums for the state under consideration to be used under Item 2 or Item 3, above, as the case may be.

II. LOSSES.

Losses incurred in the state, less amounts recovered or recoverable on risks reinsured, whether in authorized or unauthorized companies, as shown in the exhibit of state business in the Annual Statement after allowing for adjustment, if any, to include all reinsurances as set forth above. *Incurred Losses.*

III. EXPENSES.

Direct Expense.

1. *Specific Expenses.* All agency commissions and other agency expenses, taxes, licenses, fees, assessments, membership in rating bureaux or underwriters' associations, if any, operating in compliance with or permitted by law, advertising required by law, special agents' salaries and expenses, loss adjustment expenses, expenses for litigation or legal advice, maps, inspections, surveys and other expenses incurred and paid directly and specifically for the purpose of doing business in the state under consideration.

Primary Overhead.

2. *General Expenses.* That proportion of general or overhead expenses such as salaries of officers and home office employees, printing and stationery, federal government taxes, postage, telegrams, telephone and express, mercantile reports, advertising, home office maintenance expenses including light, heat, janitor service, etc., furniture and fixtures, books of account, and other expenses not chargeable to the business in any particular state, which the net premiums received from business in the state under consideration bear to all net premiums received by the company for the current year.

Adjustment to Incurred Basis.

3. *Incurred Expenses.* In order to put Item 2 on an *incurred* basis, there should be included therein not only expenses of the character enumerated and described when actually *paid,* but also those, liability for which has been *incurred* and is capable of determination or estimate at the time of making up the annual statement. Hence, the items on Page 5 of the Annual Statement, representing, respectively, "Salaries, rents, expenses, bills, accounts, fees, etc., due or accrued,"—"Estimated amount hereafter payable for federal, state and other taxes based upon the business of the year of this statement," and "contingent commissions or other charges due or accrued" should be taken into consideration, and on the *increase* or *decrease* in such items during the year a like proportion to that provided in Item 2 for general expenses paid should be figured, and the result

should be used to increase the expenses if the above reserves showed an increase, or to reduce the expenses if they showed a decrease.

4. *Departmental Expenses.* If the business in the state under consideration, or any part thereof, is operated through a departmental office, or is subject to expenses incurred in common with the business in some other state or group of states, and not separated and specifically charged to the results of each individual state, such secondary overhead expenses should be distributed among the states for which they were incurred by a like process to that employed for the distribution of general expenses or primary overhead expenses, as outlined in paragraph 2; the only difference being that in this case the distribution is confined to the results of the limited number of states involved, in the proportion that the premiums received on business in each, bears to the sum of the premiums received on business in all of them. *Secondary Overhead.*

IV. ALLOWANCE FOR CONFLAGRATION HAZARD.

No formula for computing underwriting profit or loss is correct which does not allow for the unusual and extraordinary losses commonly called conflagrations, but which should include large, general and sweeping losses by hail and tornado as well as by fire. Recently enacted laws clearly recognize this principle. For example—that enacted in Colorado in the Legislative Session of 1919, provides as follows: "In determining the question of a reasonable underwriting profit, the Commissioner of Insurance, as a protection to policyholders, shall give proper and reasonable consideration to the conflagration liability within and without the state." *Necessity for Consideration* *Precedents.*

V. UNDERWRITING PROFIT.

The remainder of net premiums earned (I), after deducting losses (II), expenses (III) and allowance for conflagration hazard (IV), will be the underwriting *Derivation.*

profit—which the answer to question "First" specifies should equal 5% of the net premiums earned, viz.:

Formula.

Earned Premiums (Net)			.....
Incurred Losses (Net)		.....	
Expenses Incurred:			
Specific	.....		
General	.....		
Departmental	.....		
Total Expenses		.....	
Allowance for Conflagration Hazard		.....	.....
Underwriting profit or loss			.....

APPENDIX DEFINING THE LEGAL STATUS OF THE UNEARNED PREMIUM RESERVE OF STOCK FIRE INSURANCE COMPANIES

Summary of Decisions.

The courts in the various states have many times been called upon to determine the legal status of this reserve, and have uniformly held that

First: It is the exclusive property of the company and not such as is held in trust for the benefit of its policyholders;

Second: The right of the insured to recover a part of his premium is a mere incident of the contract not contemplated by either party at the inception of the contract;

Third: The right to recover is so remote as not to be worthy of consideration in determining the surplus of the company;

Fourth: A statutory provision that the so-called unearned premium reserve is to be treated as a liability by the company, and an insurance commissioner for the purpose of bookkeeping and a financial report does not change its character from an asset of the company to a liability.

Nature and Origin of Reserve.

In order to determine the status of the reserve it is necessary to determine if it is property, and, if so, to whom such property belongs. Of course, as it is money or its equivalent, it is property. It is paid over by the assured to the company and treated by him as an item of expense. He has lessened the value of his assets by that sum. The assets of the company have been increased in the same manner. The company may use it in the payment of any claim or indebtedness of any kind which it may have, or may use it in the transaction or furtherance of its business in any manner, and the proceeds thereof inure solely to the benefit of the company.

In the case of the People's Fire Insurance Co. vs. Parker, 34 N. J. L. 479, the Supreme Court says:

Effect of Liability by Contingency of Loss.

"It is liable to the contingency of loss upon the policies issued, but it is as much the property of the company and as fully under its control as the capital stock paid in. It is asserted that the company does not actually own these premiums because they are subject to the risks taken until the policies expire by limitation, and that this constitutes a liability in the nature of an indebtedness against the company. This consideration cannot affect the character of the fund as an accumulated surplus. The liability is contingent; it may or may not actually attach, and, if it does, it will reach to and affect the capital stock and such premiums as have been received on expired risks as fully as those received on unexpired risks."

The Court of Errors and Appeals of New Jersey affirmed the judgment of the Supreme Court, and in passing upon the question holds:

Effect of Provision for Return of Premium Upon Cancellation.

"The usual stipulation that in the event of a transfer of the property insured and the termination of the insurer's risk a part of the premium may be reclaimed, proportionate to the time the risk has to run is but a contingency and not such a charge upon the premium that it takes away the right of property and ownership. Such liability to return is in the same class as possible losses by fire, against which provision is made by the capital stock and the reserve fund of the corporation, which is called accumulated surplus. It is not a specific charge on the premium paid, but a possible liability that may be claimed out of the general assets of the company." (People's Fire Insurance Co. vs. Parker, 35 N. J. L. 575.)

In the case of Kenton Insurance Company vs. City of Covington, 86 Ky. 213, the court holds the unearned

premium reserve is the property of the company, and says:

> "The Act of March 12, 1870, with reference to the payment of dividends, requiring that no dividends shall be made of this reserve fund, does not divest this corporation of its right of property in it; *or to use and invest it for the benefit of its stockholders.*"

Effect of Legislation as to Payment of Dividends.

The most recent case touching on property rights is the case of the Oklahoma National Life Insurance Company, 173 Pac. 376, in which the court expresses its opinion as follows:

> "We therefore conclude that the portion of the assets of the corporation which represents the reserve is as much the property of the corporation as that portion which represents the contributions of the stockholders or funds derived from other sources."

Comparison of With Other Capital Elements.

In the case of the Westchester Fire Insurance Co. vs. Davenport, 91 N. Y. 575, the court says:

> "To say that such receipts constitute a trust fund held by an insurance company for the use of the policyholders or that it is a liability of the company in any such sense * * * is contrary to reason and is not sustained by any authority known to us. The insurer in fact not only acquires the absolute ownership of such moneys when received for premiums, but is by the lapse of time soon freed from liability to repay any part thereof to the policyholders except in those occasional instances where the loss occurs."

Negation of Trust Relation.

Referring to the opinion in the case of the Detroit F. & M. Insurance Co. vs. Hartz, 132 Mich. 518, decided March 7, 1903, in which the court, in passing upon the proposition that the fund was a liability because, first, it is treated as a liability by the company and the insurance commissioner for the purpose of bookkeeping

Irrelevancy of Statement and Accounting Treatment as Determining Ownership.

and a financial report, and, second, for the reason that the policies of the company are subject to cancellation and an unearned premium may in that event be demanded by the insured, said:

> "Neither of these justifies such an assertion. The fund called 'reserve fund' is the property of the company. For the purpose of protection to patrons of the company, the law requires it to be kept in a fund called a 'reinsurance reserve fund' so that the company may have the means to reinsure its risks if necessary, which it is given power to do; but its character is not changed on that account."

Further Decisions.

The same line of reasoning is uniformly followed in other cases decided by the courts. For additional decisions see People ex rel Manhattan Fire Insurance Company, 76 N. Y. 64; Home Fire Insurance Company vs. Lynch, 19 Utah 189; Insurance Company vs. Cappellar, 38 Ohio State, 560; City of Yale vs. Michigan Farmers' Mutual Insurance Co., 179 Mich. 254; Trenton vs. Standard Fire Insurance Company, 77 N. J. L. 656.

Summary of Decisions.

It is evident from the above that the courts uniformly and properly held that the unearned premium reserve is the property of the corporation. It is further evidenced by the fact that the requirement of the various states does not deprive a claimant of his right to attach such moneys nor prohibit a company from using same to meet any of its obligations other than the payment of dividends. It is as available for the payments of any claim as the moneys paid in for capital stock or derived from any other sources. By every test this reserve is as truly the property of the company as the surplus paid in by the stockholders, and there is no more obligation on the part of the company to meet its claims from this reserve than there is from its paid-in surplus or capital. Its ownership in the company is as entire and complete as the ownership in any other of its assets.

Creditors' Claims.

In the case of impairment by reason of insufficient assets, the policyholder derives no greater benefit, nor has any special privilege over any other claimant in the distribution of the reserve. It is true, the policyholder would have a right to enforce a claim against the receiver if he had a claim arising under a policy contract, but he would be on the same plane as any other creditor in the distribution of the assets of the company, including this so-called reserve.

Conclusion.

In the interest of brevity we have not attempted to cite all of the decisions nor present more than enough, we think, to satisfy the most skeptical that the unearned premium reserve is the property of the company and is invested for the benefit of the stockholders, for, as held in the case of Kenton Insurance Company vs. City of Covington (above cited), an act with reference to the payment of dividends requiring that no dividends shall be made of this reserve does not divest the corporation of its right of property in it, or to use it and invest it for the benefit of its stockholders.

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